$40.00 ANNUALLY
40 Letters Per Year

Dow Theory Letters

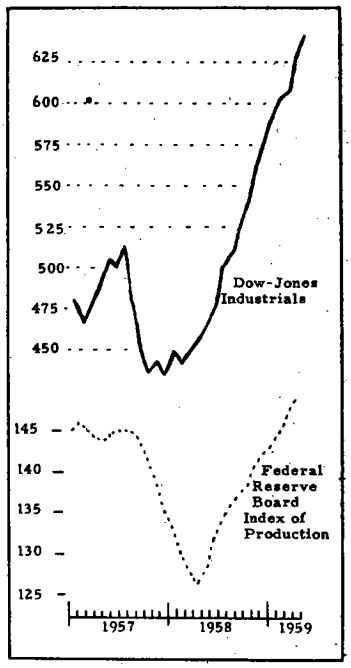
"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

Registered with the Securities and Exchange Commission

Copyright 1959 - Richard Russell

THE BAROMETER. A ship's captain, noting that his barometer reads "fair weather", does not insist on an exact prediction of "three sunny days with a mean temperature of 76." Nevertheless, the captain plans on fair weather ahead knowing that his instrument is a barometer, not a micrometer, and that the fair weather prediction may hold for a few hours, a day, or a week. The barometer may also reverse its decision at any time, and indeed if it could not, it would be of little use to a man who is dealing with anything as fickle as the weather. The pattern of the averages provides much the same type of forecast, and although the price movements cannot tell us exactly where the Federal Reserve Production Index will be three months hence, they can and do indicate future changes in the fortunes of business.



Amid the general optimism of July, 1957, the Fed's Production Index hit a high of 145 (see chart). The D-J industrials hit a peak of 520.77 that same month, then turned unexpectedly down. While the Fed's Index faltered, the D-J industrials plunged 100 points lower to 419.79, thereby predicting the worst recession of the post-war period. The stock market hit bottom in October, 1957, but to the amazement of Wall Street and the public, the averages then commenced a long, relentless climb back to the highs. The Fed's Index continued to drop, however, touching a recession low of 126 in April, 1958. In other words, the averages had discounted the worst and turned up a full six months before the economy had even hit bottom!

The bullish vision of the averages was universally doubted, and a 6 million share short position backed the widely held belief that the advancing stock market had taken leave of its senses. In September, 1958, another event of far-reaching importance took place -- the D-J industrials bettered their 521.05 top established in 1956, and stocks soared into uncharted territory. A few days later in our Letter of September 19, 1958, I wrote as follows:

"WHAT ARE THE AVERAGES SAYING? It has been stated over and over in these Letters that the public is always concerned with the present and the past; the averages are concerned only with the future. It is the business of the averages to predict future events. This principle seems almost impossible for the public and a good portion of new readers to grasp. There is nothing in the newspapers to justify the price of stocks; there will be nothing in them tomorrow. The averages, when they belie the economy, are 'talking' about business six months to a year away. Readers who were skeptical of any upturn in the economy three months ago need merely read the papers to see that most analysts are now reporting an upturn, an upturn which the averages saw last November, December, and January. By going through their all-time highs the industrials are now saying that the greatest boom in history will be a reality within a year. Those who doubt the predictive ability of the averages will have ample time to check their validity over the coming year."

As seen on the chart, the Fed's Index has recently hit an all time high of 152; the July figure will probably be even higher. When inventories are building up (as they are now -- at the rate of 10 billion a year) the effect on the economy is extremely bullish. But eventually the build-up must end, and the public will have its fill of new houses, cars, automatic washers and the credit loans which invariably accompany them. When this happens the "wise money" in the stock market will have already begun reducing its inventory. And readers should remember that the "inventory" on Wall Street is more eagerly watched, carefully appraised, and easily liquidated than any merchandise which the most discerning businessman may have stacked on his shelves.

STEEL STRIKE. Although the market seldom reacts to similar events in exactly the same way, it is usually profitable to compare current situations with their counterpart in former years. We cannot know how long the current steel strike will last, nor can we determine how the market will react to a long strike vs. a short strike, a wage increase vs. a "hold the line" policy. At any rate, here is what happened in former years when the primary trend was up, as it is now.

During June 2 -- July 26, 1952, a protracted steel strike took place. From a high of 275 established in January, 1952, the industrials headed steadily down, hitting a low of 257 in early May. This low was the point at which the market discounted the worst that could be seen in the strike period ahead. Following the May lows, the market continued up all during the strike, reaching a high of 280 within a few days of the strike's end. A reaction promptly set in which took industrials from 280 (late July) back to 263 (October).

A steel strike occurred during July 1 -- August 3, 1956. From a high of 516 hit early in May, industrials plunged to 463 by the end of that month. Here again the worst effects of the coming steel strike were discounted by the market in advance. The market headed up in May, continued up all during the steel strike, and industrials touched their high of 520 within a few days of the strike's end. No sooner had the strike ended, however, than the market turned sharply down, establishing a low of 468 in early October, 1956.

The current situation is interesting. Industrials hit a high at W (see chart), then declined rapidly to X, at which point I wrote that the averages were probably discounting the worst that could be seen in the period ahead. Apparently the worst was well discounted at X, for since then the market has continued unabatedly up, despite the calling of a steel strike. If history now repeats itself, stocks will trend higher thoughout the strike. At or a little after the settlement, a period of reaction may be expected.

CONFIRMATION. Following Letter 71 the rail average, which had been poised just under its 169.67 high (W - see chart), rallied sharply to hit its best price since 1956. The carriers thereby "confirmed" the recent action of the industrials, and the secondary trend of the market was definitely reaffirmed as being up. The rails are now less than 10 points from their 1956 peak of 181.23, a level which seemed virtually impossible six months ago.

According to Dow Theory, bullish inferences may be drawn prior to confirmations, and in fact, all our purchases over the last few years were made on the assumption that this was a bull market and that the rails would eventually confirm. Those who insisted upon waiting for a confirmation (instead of purchasing at buy-spots) would not have done any buying since 1956! I have often said that I believe the primary trend will be reaffirmed (as being bullish) by a final rail confirmation over the 1956 high. Industrials bettered their 1956 high last September, 1958. This was only half of a primary bull signal; a rail confirmation would constitute the other half.

Yet if rails now better their '56 high I would not attach any particularly bullish significance to that event because (1) it would have come so long after the industrial penetration,

(2) it would have taken place in the third phase of an ageing bull market. In other words, a rail confirmation would simply mean that the last technical requirement for our bullish designation of the primary trend had been met.

MARKET. The newspapers always make fascinating reading when a technical correction occurs. The steel negotiations (which a day earlier were deemed bullish) suddenly become "bearish", the international news becomes an "unsettling" influence on the market, and a few "bearish advisory services" are blamed for bringing out a wave of selling.

Letter 71 called attention to the recent steep rally (Z-A), and I stated that "it would be normal to have an equally sharp decline correcting 1/3 to 2/3 of the Z-A advance." July 13 saw a sharp 6 point drop in industrials as volume diminished. Indecisive movements followed on July 14 and 15 as volume held steady. The slightly lower volume on the decline from A may be the key to the next broad direction of the market. From whatever decline lows are now being established, an attack on the A highs may be expected. A bettering of those highs (industrials 663.81, rails 173.56) on increasing volume would imply further near-term gains. A refusal of one or both averages to hurdle the A highs followed by a decline which violates the last lows (particularly on heavy volume) would be a danger signal, and in this case traders could protect themselves accordingly.

STOCKS. The selectivity in the market is almost spectacular. Oils show consistent weakness and more recently oil field equipment stocks have turned weak. Aircrafts show up very poorly: it seems that something fundamental and quite drastic will have to occur before this group makes a come-back. Meat packers, on the other hand, (Morell, Armour, Swift) are heading up and are probably buys in this area. The tight money rates are helping the bank and finance companies and Commercial Credit and C.I.T. look excellent for conservative accounts, as do Bankers Trust and Chase Manhattan. Until recently I have been switching out of weak situations into stronger ones, but after making a sale I now hold the cash. The reason-- if I did not follow this procedure, I would find myself fully committed all the way to the top.

TECHNICAL INDICATOR. The average yield on the D-J industrials dropped to 2.97% last week. This is the first time in history that this yield has been under 3%. Those who purchase stock here should realize that they are no longer buying values; a collection of stocks yielding 2-3% is hardly something to "put away for one's old age".

CORRECTION. The address of Traders Research, Inc. (mentioned last week) should read as follows: Suite 375, Arcade Bldg., St. Louis 1, Mo. The daily charted history of the D-J averages with volume of transactions (1897 to the present) may be obtained from this organization.

(Written July 15 - after the close.)